BEFORE THE ILLINOIS COMMERCE COMMISSION

Docket No. 03-0553

Rebuttal Testimony of Dr. Alan S. Frankel
On Behalf of SBC Illinois

SBC Illinois Exhibit 2.1

March 10, 2004

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DIRECT REBUTTAL TESTIMONY OF DR. ALAN S. FRANKEL ON BEHALF OF SBC ILLINOIS

I. INTRODUCTION

Q.1 Please state your name and position.

A.1 My name is Alan S. Frankel. I am a Director in the Evanston office of LECG Corporation. My business address is 1603 Orrington Avenue, Suite 1500, Evanston, IL, 60201.

Q.2 Are you the same Alan Frankel who testified previously in this proceeding?

A.2 Yes.

Q.3 What is the purpose of your Rebuttal Testimony?

A.3 This Rebuttal Testimony responds to the Direct Testimony filed by Robert F. Koch and A. Olusanjo Omoniyi of the Illinois Commerce Commission. First, I explain that Mr. Koch and Mr. Omoniyi make a fundamental economic error by equating alleged preclusion from serving an individual customer with alleged foreclosure of competitors in the marketplace. Second, I explain that their conclusions concerning alleged anticompetitive effects of SBCI's early termination fees ("ETFs") are speculative, unsupported, and contradicted by other elements of their respective testimonies. Third, I explain that a full rulemaking proceeding with respect to the early termination provisions of term contracts such as those at issue in this proceeding is not justified by the economic evidence, the testimony of Mr. Koch, or the testimony of Mr. Omoniyi.

II. THE STAFF WITNESSES CONFUSE INCENTIVES FACING INDIVIDUAL CUSTOMERS FOR "ANTICOMPETITIVE" EFFECTS IN THE MARKETPLACE

Q.4 What effects does Commission staff witness Mr. Koch contend result from the ETF provisions of SBC Illinois' and other carriers' contracts?

A.4 Mr. Koch states "the TDS proposal [to compel SBC Illinois and its business customers to adopt retrospective 'return of the discount' ETF provisions in all contracts rather than forward-looking ETFs] is reasonable to the customer and has a positive impact on competition in SBCI's service territory."[1] Demonstrating that forward-looking ETFs have an adverse impact on competition, however, would require a showing that (1) the ETF provisions inefficiently prevent individual business customers from switching providers; (2) the disincentive for customers to switch harms the individual customer without generating benefits that offset the harm; (3) the number of customers subject to term contracts with ETF provisions accounts for a large fraction of customers in the market; (4) the duration of the contracts tends to be long enough to remove a substantial fraction of potential customers from the market for an extended period of time; and (5) a reduction of customer turnover caused by long term contracts with a large fraction of customers in the market deters firms from entering the market, prevents them from being effective competitors, and enables SBC Illinois to increase prices, reduce quality, or degrade its service. TDS, however, did not demonstrate that any of these conditions have been met (much less all of them) and Mr. Koch simply repeats TDS Metrocom's error in equating ease of an individual customer's post-contract switching with the competitiveness of the market. Mr. Koch testifies:

> **Q. Can SBCI's proposed termination penalties be viewed as a barrier to competitive entry?**
>
> A. As the example that I provided previously in this testimony illustrates, SBCI's proposal may make it prohibitive for a competing carrier to acquire the customer, depending on the number of months remaining on the contract. To make it worthwhile for a customer to want to switch carriers, a CLEC would probably need to offer deeper discounts than what SBCI offers to the customer...[2]

Although the question quoted above asked whether the ETF provisions of contracts between SBC Illinois and its business customers constitute a "barrier to competitive entry," Mr. Koch merely repeats the observation that an individual customer *that has already entered into a contract* with a forward-looking termination fee must make a payment to abandon its contractual commitment. He offers no analysis of competition to enlist customers in term contracts or whether so many customers are already enlisted in long duration contracts with SBC Illinois that the term contracts and their ETFs might constitute a "barrier to entry," let alone whether the allegedly anticompetitive effects outweigh the corresponding beneficial effects. In fact, SBC Illinois' ETF practices did not deter TDS Metrocom from entering Illinois or expanding its competitive presence in Illinois; to the contrary, "between when the Ascent Order was put in place and now, TDS entered the Illinois market…"[3] and "TDS Metrocom has a made substantial investment to serve local exchange telecommunications customers in Illinois. TDS Metrocom has invested over $30 million in its Illinois CLEC operations in the last two years."[4]

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1 *Koch Direct*, p. 4.

2 *Koch Direct*, pp. 11-12 (emphasis added).

3 *Omoniyi Direct*, p. 15.

4 *Complaint*, ¶3.

Q.5 Does Mr. Koch in fact identify beneficial effects of the ETF provisions of SBC Illinois' term contracts?

A.5 Yes. Mr. Koch agrees with my Direct Testimony on this point.[5] He acknowledges that:

> [P]lacing excessive restrictions on the ability of SBCI to impose termination penalties could potentially negatively impact customers. Such limits on penalties make it less attractive for a carrier such as SBCI to develop discount offerings. The term of the contract, and the penalty associated with it, provides revenue stability for a carrier. It is this revenue stability benefit to the carrier that makes it worthwhile to offer discounts to the customer. By severely limiting the revenue stability benefit to SBCI, the discount benefit to SBCI customers will be less likely to come to fruition.[6]

Q.6 What effects does Staff witness Mr. Omoniyi claim result from the ETF provisions of SBC Illinois term contracts?

A.6 Mr. Omoniyi observes that SBC Illinois' ETF tends to deter early terminations.[7] Of course, any ETF – including SBC Illinois' current and proposed ETFs and TDS Metrocom's ETFs – will tend to deter early terminations relative to a hypothetical situation in which early terminations are permitted but there is no ETF. That is the entire point of all ETFs. Service providers will not offer a discount for a term contract that can be abandoned without notice and at no cost to the customer. Such a plan would not constitute an economically meaningful term contract.

Q.7 Does Mr. Omoniyi offer any opinion regarding TDS Metrocom's claim that SBC Illinois' ETF is "anticompetitive"?

A.7 Mr. Omoniyi states "[I]t is my belief that TDS' contention that SBC's [about to be discontinued] termination penalties are unreasonable and anti-competitive in nature is

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5 *Frankel Direct*, Section II.

6 *Koch Direct*, p. 5.

true."[8] However, Mr. Omoniyi offers no analysis to support this belief, even with respect to the SBC Illinois ETF practices in place when TDS filed its Complaint. In particular, like TDS Metrocom's witnesses and Mr. Koch, he fails to show or even explain how contracts of unstated duration with an unstated share of customers in the marketplace are "anticompetitive." Mr. Omoniyi declines to offer any opinion concerning the competitiveness of the new ETF practices that SBC Illinois is in the process of standardizing, testifying that "as of now, it is simply impossible to judge the cost and policy implications on competition and customers until all the details are known."[9]

Q.8 Can you summarize how Mr. Koch and Mr. Omoniyi have improperly linked the fact that individual customers are under contract with alleged anticompetitive effects in the marketplace?

A.8 Absent any market context in which to analyze the effects of SBC Illinois' practices, it is impossible to reach any credible conclusion that its ETF practices are anticompetitive. Mr. Koch recognizes the competitive *benefits* that flow from the commitment generated by the ETF provisions of SBC Illinois' term contracts. Yet, Mr. Koch and Mr. Omoniyi accept uncritically and without any further support TDS Metrocom's vague contention that the existence of business customers unlikely to abandon existing term contracts with SBC Illinois necessarily and logically must be "anticompetitive." In my Direct Testimony, I provided evidence showing that a large fraction of business customers are

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7 *Omoniyi Direct*, pp. 8-10.

8 *Omoniyi Direct*, p. 11.

9 *Omoniyi Direct*, p. 13.

not subject for long periods of time to SBC Illinois term contracts. Neither Mr. Koch nor Mr. Omoniyi addresses this evidence. In fact, nothing in the testimony of either Mr. Koch or Mr. Omoniyi would be affected in any way if there were dozens of competitors each accounting for a small share of customers in the market. Even a single contract with an ETF that is "unreasonable" in the opinion of Mr. Koch and Mr. Omoniyi – substituting their own business judgment for that of SBC Illinois and, according to Mr. Koch, that of most other carriers in Illinois[10] – is apparently sufficient in their view to trigger "anticompetitive" effects – otherwise, they would need to analyze the aggregate effect of such contracts, and they offer no such analysis.

III. MR. KOCH OFFERS UNSUPPORTED, CONTRADICTORY AND SPECULATIVE OPINIONS CONCERNING THE ALLEGED "ANTICOMPETITIVE" EFFECTS OF SBC ILLINOIS' ETFS

Q.9 Does Mr. Koch claim that forward-looking ETFs such as those being standardized by SBC Illinois always generate termination fees that deter customers from switching carriers?

A.9 No. Mr. Koch concedes that his conclusion hinges on timing: "SBCI's proposal <u>may</u> make it prohibitive for a competing carrier to acquire the customer, <u>depending on the number of months remaining on the contract</u>."[11]

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[10] *Koch Direct*, pp. 5-6.

[11] *Koch Direct*, p. 11 (emphasis added).

Q.10 Does Mr. Koch claim that forward-looking ETFs such as those being standardized by SBC Illinois always generate termination fees that are greater than the "return the discount" ETFs that TDS Metrocom advocates SBC Illinois should be compelled to adopt?

A.10 No. Mr. Koch concedes "I am [ ] certain that SBCI could produce examples where its proposal is more favorable to customers under certain circumstances, such as during the last few months of a lengthy term contract."[12] In fact, the difference in termination charges that result from the two types of ETFs depends on the level of the discounts offered for contracts of different duration and the point in time during the contract term at which the ETF is assessed. A forward-looking discount declines over time and tends to be relatively low as the contract nears expiration.[13] A retrospective "return the discount" ETF, on the other hand, increases continuously from the date of the most recent discount tier achieved until the expiration of the contract. In the earliest part of a contract term, the forward-looking ETF tends to be higher, and in the latter periods the "give back the discount" ETF tends to be higher.

Q.11 Does Mr. Koch cite any evidence suggesting that the early period of existing contracts is the more typical situation in which business customers might contemplate switching carriers?

A.11 No. In fact, Mr. Koch testifies, "I would not know where to begin defining a typical customer."[14]

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12 *Koch Direct*, p. 8 (emphasis added).

13 *Koch Direct*, p. 8.

14 *Koch Direct*, p. 8 (emphasis added).

Q.12 Does Mr. Koch offer an opinion regarding how frequently the TDS Metrocom proposal would result in a lower ETF than the SBC Illinois proposal for customers who might contemplate switching?

A.12 Yes. Mr. Koch testifies "It is my opinion that, in most cases, the TDS termination liability proposal would be more favorable to customers than the SBC proposal."[15] He states firmly: "[I]t is my opinion that SBCI's proposal would produce a more significant termination liability than the TDS proposal in almost all circumstances."[16]

Q.13 Upon what does he base his conclusion that, in most cases, the TDS proposal is more favorable?

A.13 Mr. Koch provides a single hypothetical example that he claims demonstrates that the TDS Metrocom proposal results in a lower ETF using "reasonable assumptions."[17]

Q.14 Is it simple to compare how the two proposals generate their respective ETFs?

A.14 No. Mr. Koch explains that the "termination liability" in the two cases "is not easily comparable."[18]

Q.15 What is the nature of his example?

A.15 Mr. Koch provides an example in which a Centrex customer selected a three-year minimum revenue commitment contract that offered a 20% discount compared to month-to-month pricing, when there was also a one-year contract available that offered a 10% discount. He assumes that a customer seeks to terminate the contract after two years have

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15 *Koch Direct*, p. 8 (emphasis added).

16 *Koch Direct*, p. 6 (emphasis added).

17 *Koch Direct*, pp. 7-8.

18 *Koch Direct*, p. 6.

elapsed. He computes a 25% forward-looking ETF and a "give back the discount" ETF and claims this example shows that that the forward-looking ETF is more expensive to the customer.

Q.16 Are Mr. Koch's computations with respect to this example accurate?

A.16 No. Mr. Koch claims that one can simply compare the 25% ETF on one-year's worth of remaining revenue to the 10% difference between the discount levels on the two-years' worth of past revenue (or 20% of a single-year's commitment) and observe that 25% exceeds 20%. This computation is wrong. Schedule AF-R1 shows the correct computation. His mistake arises from the fact that the "give back the discount" approach is computed based on a percentage of the pre-discount price, while the forward-looking ETF is based on a percentage of the after-discount price.

Q.17 When you correct Mr. Koch's error, does his hypothetical example show that the SBC Illinois method result in a higher ETF than the TDS Metrocom method in "almost all circumstances"?

A.17 No. In his example, the two methods produce identical ETFs after two years of a three-year agreement. In each subsequent month – the entire third year of the agreement, not just the last few months – the SBC Illinois method produces a lower ETF than the TDS Metrocom method. In fact, in the final four months of his example, the TDS Metrocom ETF equals or exceeds 100% of remaining contract revenue.

Q.18 Is it reasonable to assume that the early portion of a contract is more relevant than the latter period in analyzing whether term contracts with ETFs might foreclose competition?

A.18 No. In fact, one could easily turn TDS Metrocom's argument on its head in this case. It makes no more sense for TDS Metrocom, Mr. Koch, or Mr. Omoniyi to assert that SBC Illinois ETFs are "unreasonable" or "anticompetitive" in the early months of a contract than it does for SBC Illinois or other competitors to claim that TDS Metrocom's ETF is "unreasonably" high and "anticompetitive" in the final months of its contracts. TDS Metrocom's method ensures that late in the contract period it does not have to compete hard to keep its customers. It is reasonable to assume that the ETF a customer faces during the latter portion of a contract is more important than the ETF it faces during the earlier portion of a contract, because it is natural for competitive rivalry to accelerate with respect to particular customers as contracts near expiration.

Q.19 Have you analyzed the EFTs that would result from actual SBC Illinois term contracts using the TDS Metrocom proposal and the SBC Illinois proposal?

A.19 Yes. Schedule AF-R2 shows the ETFs that result using the SBC Illinois' Centrex three-year contract terms described by Mr. Gillespie in his Rebuttal Testimony. Contrary to Mr. Koch's assumption, no one-year contract term contract is offered for Centrex service. The ETFs computed using TDS Metrocom's proposal exceed those computed using the SBC Illinois proposal for 24 of the 35 months, or 69% of the months. In each of the last twelve months, the TDS Metrocom ETF exceeds 100% of the remaining contract revenue. A customer terminating just one month early would incur an ETF nearly nineteen times the cost of paying for the final month of service.

Schedule AF-R3 shows the ETFs that result using the SBC Illinois' DS1 one-year, two-year and three-year contract terms described by Mr. Gillespie. The ETFs computed using TDS Metrocom's proposal exceed those computed using the SBC Illinois proposal in 22 of the 35 months, or 63% of the months. During nine of the 35 months, the TDS Metrocom ETF exceeds 100% of remaining contract revenue.

IV. MR. OMONIYI IS MISTAKEN IN HIS ASSUMPTIONS AND CLAIMS ABOUT CONTRACT DAMAGES AND THE EFFECTS OF ETFS

Q.20 Why does Mr. Omoniyi claim that SBC Illinois' forward-looking ETFs are unreasonable and anticompetitive?

A.20 Mr. Omoniyi gives several related explanations. First, he simply attaches pejorative labels to SBC Illinois' ETFs, calling them "penalties" that are "sizeable," "relatively large amounts," "high," and "substantial" without providing any basis upon which to evaluate these vague and subjective concepts.[19] He cites TDS' claim that some SBC Illinois ETFs "range between $12,800 and $3,400,000," without providing any context in which to judge such amounts.

He then claims that the disincentive for individual customers to switch during their contract term "will likely reduce the number of customers that all carriers can compete for in the marketplace."

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[19] *Omoniyi Direct*, pp. 8-10.

Q.21 How do you respond to Mr. Omoniyi's allegation that SBC Illinois' ETFs make it unlikely that a customer will change carriers?

A.21 It is not the ETF that makes it unlikely that a customer will change; rather, it is the existence of a term contract. TDS Metrocom does not object to the use of term contracts, and uses them itself. The ETF merely simplifies what could otherwise be costly and contentious litigation over damages for breach of contract. That said, TDS Metrocom's ETFs also make it less likely that a customer will switch carriers, especially in what otherwise is the most likely competitive window when the contract nears expiration.

Q.22 How do you respond to Mr. Omoniyi's allegation that SBC Illinois' ETF methodology will reduce the number of customers that all carriers can compete for in the marketplace?

A.22 SBC Illinois' contracts are not exclusive. A business customer is not precluded from obtaining the same or other services at the same location or its other locations from competing carriers. Even if the customer chooses to obtain all of its services from SBC Illinois, it is wrong to consider that customer to be unavailable to competitors. Customer contracts are continuously expiring and other customers, such as new businesses and businesses operating on a month-to-month basis, are available at all times. Mr. Omoniyi implicitly recognizes that it is important to analyze the size of the market and the extent to which long-term contracts might, in fact, foreclose competition. Mr. Omoniyi, however, does not provide any analysis of the proportion of customers in the marketplace allegedly locked into SBC Illinois term contracts or for how long, and he ignores entirely the evidence I submitted showing that most customers in the market are not locked into long term SBC Illinois contracts.

Q.23 How do you respond to Mr. Omoniyi's criticism that customers are being required to pay for services that are not being offered or provided to them as a result of SBC Illinois' ETFs?

A.23 This allegation makes no sense. It cannot be claimed that services are not being "offered" to a customer when SBC Illinois has already executed a contract to supply those services. A customer that has executed a contract to purchase service and later seeks to cancel such a contract itself has chosen not to take services; it is wrong to characterize such a situation as if SBC Illinois is refusing to offer or provide service.

Q.24 Does Mr. Omoniyi establish that TDS Metrocom's methodology avoids the problems he alleges?

A.24 No. Mr. Omoniyi provides no such analysis. He offers no opinions relating to the reasonableness or competitiveness of TDS Metrocom's ETFs in the latter stages of a contract term. That is not to say that TDS Metrocom's ETFs necessarily have anticompetitive effects, but there is no more evidence to support a conclusion that SBC Illinois' ETFs cause anticompetitive effects than there is to support such a finding for TDS Metrocom's own ETFs.

V. A COMPREHENSIVE RULEMAKING PROCEEDING WOULD IMPOSE UNNECESSARY COSTS AND HARM COMPETITION

Q.25 Why do Mr. Koch and Mr. Omoniyi claim that a general, industry-wide rulemaking proceeding is warranted?

A.25 Mr. Omoniyi explains his reasoning, testifying "the advent of these issues and the Ascent docket less than two years ago, when a similar set of issues had been addressed, shows that early termination penalty policies need to be addressed in greater detail on an industry-wide basis by the Commission."[20] He forecasts: "Prospectively speaking, the Commission may end up re-litigating the issue of early termination penalty policies again if other CLECs, either new entrants to the Illinois market or existing Illinois CLECs, file similar complaints. Early termination complaints, moreover, could be filed against ILECs other than SBC. Thus, the issue of early termination penalty policies appears to be an issue that is likely to recur unless there is an industry-wide policy in place."[21]

Mr. Koch cites "fairness" in the sense that all carriers, he believes, should be subject to the same restrictions on their competitive freedom and should have the same ETF provisions.[22] He, like Mr. Omoniyi, also claims that it is simpler and less burdensome to regulate the entire industry, as he expects the Commission to be confronted with similar claims again in the future, with respect also to LECs other than SBC Illinois.

Q.26 Are these reasons logically justified, from an economic perspective?

A.26 No. It is true that if the Commission decides to regulate this aspect of SBC Illinois' competitively negotiated contracts, that decision may well induce other petitioners to try to restrict the competitive process by asking the Commission to impose uniformity in the marketplace. It may be possible to reduce the number of disputes by enacting a blanket restriction on carriers' competitive freedom, but another obvious – and better – way to

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20 *Omoniyi Direct*, p. 14.

21 *Omoniyi Direct*, p. 15.

22 *Koch Direct*, pp. 5-6.

reduce and deter a large number of disputes is to refuse to restrict a widely adopted competitive practice based on vague and unsupported claims of anticompetitive effects.

Q.27 Are there any economic costs associated with a rule-making proceeding?

A.27 Yes. As Mr. Koch concedes, "a rule-making proceeding would be a large-scale endeavor."[23] The Commission's resources are finite, as are those of the various carriers. More importantly, from an economic perspective, no evidence whatever has been presented demonstrating an actual anticompetitive effect that has locked up a substantial fraction of the industry for a long period of time, let alone that the practices at issue have deterred entry or eliminated competition. The competitive process itself can work to establish competitively appropriate ETF practices. As I explained in my Direct Testimony, if Staff is correct that the TDS Metrocom methodology is superior to SBC Illinois', TDS Metrocom should be able to use that as a selling point when approaching customers.

Q.28 Are there any risks associated with the Commission action recommended by Mr. Koch and Mr. Omoniyi in this matter?

A.28 Yes. Not only is the SBC Illinois ETF policy competitively and economically justified, but also it is far from obvious that the TDS Metrocom ETF practice is competitively superior in any meaningful way. By making switching prohibitively costly near the end of a contract, the TDS Metrocom approach might be restrictive in a more competitively significant sense than the SBC Illinois ETF. If the Commission compels all other carriers to adopt the TDS Metrocom practice (when none of them have apparently done so in a widespread way, irrespective of their market shares), this could have the unintended effect of subverting and reducing efficient competition between carriers. If all customers under contract are essentially locked in towards the latter part of their contract, this may reduce the effectiveness of marketing efforts generally by all carriers. Absent any genuine evidence that the existing competitive process is inadequate to generate efficient and effective competition and contract terms, there is no justification to impose potentially ill-advised, uniform contracts that will stifle competition in important respects. If the SBC Illinois practice is harmful, competition from TDS Metrocom and others should work to induce SBC Illinois to change its practice; if the regulatory process enacts a harmful contract rule, no amount of competition that remains will be able to dislodge it. The Commission should trust the competitive process and open negotiations between businesses and carriers to find appropriate contract terms and conditions, absent clear economic evidence to justify intervention. Finally, an inefficient or harmful regulation of the ETF terms of contracts could induce some or all carriers to simply abandon the use of ETF provisions altogether, falling back on ordinary contract law remedies for breach of contract that may involve greater uncertainty, higher costs, and even less potential for early customer switching.

Q.29 Does this conclude your direct testimony?

A.29 Yes.

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[23] *Koch Direct*, p. 13.